

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:CORP:B03 – PLR-147671-03

Date:

December 11, 2003

Distributing =

Controlled =

business m =

business n =

City W =

State X =

Shareholder =

Year =

Employee =

y =

z =

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Dear _____ :

We respond to your August 6, 2003, letter requesting rulings under §§ 355 and 368(a)(1)(D) of the Internal Revenue Code and other Code provisions with respect to a proposed distribution by Distributing to Shareholder of all the stock of Controlled. Additional information was submitted in letters dated September 17, and December 8, 2003. The information submitted for consideration is summarized below.

Distributing is a State X S corporation which uses the accrual method of accounting. It is engaged in business m and business n. Distributing has a single class of voting common stock outstanding which has been held by Shareholder since Year. Distributing has submitted, for businesses m and n, information representative of the active conduct of a trade or business for each of the past five years.

Business m has a key employee ("Employee") who has City W licenses needed to operate business m. He wishes to obtain an equity interest in Distributing. In order to increase his motivation and encourage him to assemble a team to return business m to profitability, Distributing wishes to compensate Employee with Distributing stock.

In order to compensate Employee, the following transaction has been proposed:

- (i) Distributing will organize Controlled as a State X corporation. Distributing will transfer business n assets to Controlled solely in exchange for the assumption of related liabilities and all of the Controlled stock.
- (ii) Distributing will distribute all of the Controlled stock to Shareholder (the "Spin-Off").
- (iii) Distributing will issue y percent of Distributing stock to Employee as compensation within z months.

The taxpayer has made the following representations concerning the proposed transaction:

- (a) No part of the consideration to be distributed by Distributing will be received by Shareholder as a creditor, employee or in any capacity other than that of a shareholder of Distributing.
- (b) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.

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- (c) Following the Spin-Off, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees, except that Distributing and Controlled will share the services of Shareholder. Distributing and Controlled will each pay Shareholder directly for the value of her services. Two other Controlled employees will provide consultation services to Distributing for a transition period.
- (d) The Spin-Off is being carried out for the following corporate business purpose: to allow for the distribution of equity to Employee. The Spin-Off is motivated, in whole or substantial part, by this corporate business purpose.
- (e) There is no plan or intention by Shareholder to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either Distributing or Controlled after the transaction.
- (f) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction.
- (g) There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after the transaction, except in the ordinary course of business.
- (h) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed (as determined under § 357(d)) by Controlled; and (ii) the liabilities assumed (as determined under § 357(d)) by Controlled in the transaction were incurred in the ordinary course of business and are associated with the assets being transferred.
- (i) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Spin-Off.
- (j) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (k) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).

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- (l) The Spin-Off is not part of a plan or series of related transactions (within the meaning of § 355(e)), pursuant to which one or more persons will acquire, directly or indirectly, stock possessing 50 percent or more of the total combined voting power of all classes of either Distributing or Controlled stock entitled to vote, or stock possessing 50 percent or more of the total value of shares of all classes of stock of either Distributing or Controlled.
- (m) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be an S corporation pursuant to § 1362(a) on the first available date after the Spin-Off, and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

Based solely on the information submitted and the representations set forth above, we rule as follows:

- (1) The transfer by Distributing of business n assets solely in exchange for Controlled common stock and the assumption by Controlled of related liabilities, followed by the Spin-Off, will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be a “party to a reorganization” within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing on its transfer of business n assets to Controlled in exchange for Controlled common stock and the assumption by Controlled of related liabilities (§§ 357(a) and 361(a)).
- (3) No gain or loss will be recognized by Controlled on its receipt of business n assets from Distributing in exchange for Controlled common stock (§ 1032(a)).
- (4) The basis of each asset received by Controlled will equal the basis of that asset in the hands of Distributing immediately before its transfer (§ 362(b)).
- (5) The holding period of each asset received by Controlled will include the period during which Distributing held that asset (§ 1223(2)).
- (6) No gain or loss will be recognized by Distributing on the Spin-Off (§ 361(c)).
- (7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) Shareholder on the receipt of Controlled stock (§ 355(a)(1)).
- (8) The aggregate basis of Controlled common stock and Distributing common stock in the hands of Shareholder will equal the aggregate basis of the Distributing common stock held immediately prior to the Spin-Off, allocated between the

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Distributing common stock and the Controlled common stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§§ 358(a), 358(b) and 358(c)).

- (9) The holding period of the Controlled stock received by Shareholder will include the holding period of the Distributing stock with respect to which it was distributed, provided that Shareholder holds the Distributing stock as a capital asset on the date of the Spin-Off (§ 1223(1)).
- (10) Earnings and profits will be allocated between Distributing and Controlled in accordance with § 312(h) and § 1.312-10(a).
- (11) Provided that Distributing immediately distributes the stock of Controlled, Distributing's momentary ownership of Controlled's stock as part of a divisive reorganization under § 368(a)(1)(D) will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under § 1361(b)(1)(B). Therefore, Controlled will be eligible to make an S corporation election under § 1362(a) for its first taxable year, provided that Controlled otherwise meets the requirements under § 1361(b).

Except as provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion as to whether Distributing is a valid S corporation or whether Controlled is otherwise eligible to be an S corporation.

The rulings contained in this letter are predicated upon the facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for a ruling. Verification of the information, representations, and other data may be required as part of the audit process. See §§ 12.04 and 12.05 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, 44, which discuss in greater detail the revocation or modification of ruling letters. However, when the criteria in § 12.06 of Rev. Proc. 2003-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

It is important that a copy of this ruling letter be attached to the federal income tax return of each party involved for the taxable year in which the transaction covered by this letter is consummated.

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Pursuant to the power of attorney on file in this office, a copy of this letter has been sent to your authorized representative.

Sincerely,

Ken Cohen

Ken Cohen
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Corporate)

cc: